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THE DEMAND-SIDE LOCATION DETERMINANTS FOR ATTRACTING FOREIGN DIRECT INVESTMENT: THEORY AND EMPIRICS

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ABSTRACT

Foreign direct investment (FDI), reckoned as a major source of private capital, has grown phenomenally world wide in the last two decades. Developing countries receive about a third of the global FDI inflows. Although developing countries vie for more FDI, selecting a country for locating investment depends on the decision of multinational enterprises (MNE). An attempt made in this paper to identify from the literature the theoretical basis of foreign direct investment found it to be lacking. The literature emphasized more on the empirical findings of robust location determinants for understanding investment decision processes of the MNEs. It appears that countries' attractiveness improve with favorable determinants to influence MNE 's investment location decision.

Key words: Foreign direct investment, location determinants, FDI attractiveness, OLI.

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I. INTRODUCTION:

Foreign direct investment (FDI) is a major source of private capital in the world economy. In the last decade or so FDI has grown sharply worldwide, the growth rate of FDI outflow even surpassing that of the world exports (ADB, 2004). Most FDI originations and destinations, however, have been the developed countries, including the United States and the European Union. While every developing country vies to get a share of the world's FDI, about a third of it is received by the developing countries, most of which are in Asia. But even within Asia, investors favor some countries e.g. China, India, over others. Why investors go abroad, why investors favor some countries but not others, what characteristics of a country attract investors for locating FDI, and what host countries can do about to attract FDI location- have been the complex issues at the forefront of discussions among researchers and policy makers for sometime.

The purpose of this paper is to explore from a literature survey the attractiveness of the location factors for foreign direct investment by identifying motivations of the Multinational enterprises (MNE's). A lot of insights can be brought into focus through a literature review of the theoretical and empirical studies made in the past. The studies have generally covered different aspects of FDI in the manufacturing sector. Though emphasis in most studies is on the manufacturing sector, and do not specifically deal with agriculture or food processing, the theoretical and empirical underpinnings of FDI serve both sectors equally well as they are basically same for all sectors.

In trying to understand the complexity of the FDI phenomenon, one should view it from the perspectives of demand and supply of investment capital. From general economic viewpoint, supply of FDI is based on decisions by the multinational enterprises (MNEs) to invest capital in profit making ventures in another country. Such investments can be in greenfield (new) operations, but in practice capital investments largely have been made through mergers and acquisitions, made with the primary intention of earning better rates of return for their investments. MNEs select appropriate host country locations with clear motives of rent seeking. The host country, on the other hand, needs private investment capital to help in its economic development. Developing countries particularly find FDI as a source of private capital which can help in achieving their development objectives if invested in their countries. The MNEs as suppliers of investment capital, and recipient host countries as demanders, come together in the international market for investment with respective self-interest. For MNEs the objective is making profit, for host countries it is getting private capital investment that bring them together into the FDI market.

In contrast to the product market exchange, the decision of the supply-side MNEs gets priority in the choice of FDI location or sector. While the MNE's complex decision making process of selecting a particular location for FDI remains unknown as a business secret, there are certain kinds of country attributes, or determinants, that are considered in the investment decision. As a private capital supplier the MNE

evaluates whether different attributes in the host country are appropriate for its investment. Like any business transaction, the foreign direct investment decisions are made by the MNE when its motivation for FDI location favorably coincides with the host country's attractiveness of attributes. It is therefore appropriate strategy for the demand-side host country to know how to provide attractive attributes so that they may influence the MNE's decisions in favor of locating FDI in the country.

Over the last three decades extensive research on foreign direct investment has generated a vast literature on the theory and empirics of FDI. The research on the theory is aimed at basically to understand why firms become multinationals and invest abroad, and what they look for in a country to locate their investments. The empirical research on FDI, on the other hand, mostly covers three major areas: (a) determinants or factors of FDI inflows; (b) impacts of FDI inflows on the host countries' economy; and (c) attractiveness of host country determinants in influencing location decisions of the multinational enterprises (MNE). The vast literature, by and large entailing (a) and (b), contributes to the conceptual understanding as well as empirical evidences of the FDI activities.[1] The literature on (c), though limited, provides understanding of the host country factors in the light of attracting FDI. On the whole, the literature is expansive with substantive contributions on various complex issues relating to FDI, but it also abounds with many contradictions and conflicts that borders into confusion. Though the literature contains emphasis on the developing countries, there seems to be no straightforward objectives set for the developing countries. For the developing countries to attract FDI location in the competitive market it would be helpful if they have clear understanding of what attributes or factors would indeed draw MNEs' attention.

The paper is organized in six sections. Section 2 presents a brief review of the current trends in FDI. Section 3 explores the motivation of the MNEs from theoretical standpoints basically to answer the questions: why a firm becomes multinational, why it goes abroad with FDI and what attributes of the country attracts them. Section 4 reviews the literature to identify the determinants that influence FDI inflows into a host country. Section 5 provides MNEs' views on the factors that they find attractive for deciding FDI location in a host country. The paper concludes with findings from the literature survey in Section 6.

II. THE TREND OF FDI:

In the last two decades world FDI has increased phenomenally. Annual FDI inflows to both developed and developing countries have increased from $53.7 billion in 1980,to $1.4 trillion in 2000. Global FDI stock has also increased from $ 590 billion in 1982 to $ 8.2 trillion in 2000 (UNCTAD, 2004). World economic slowdown since 2001 has caused downturn in both FDI inflows and outflows. FDI inflows have declined since 2001 to $560 billion in 2003, but the prospect of upturn again is in the

[1] This study concentrates on theory, location determinants of FDI and attractiveness of host countries. Impacts of FDI have not been included in this study. For literature surveys on the impacts of FDI see Agarwal (1980), De Mello (1997), Fan (2003).

forecast (UN, 2004). Since 1996, FDI growth has overtaken the world exports growth and retained the leading position despite the downturn.

Developed countries maintained leading position in both FDI outflows and inflows. In 2000, the peak year of FDI, developed countries provided 90 percent of the world's total FDI outflows, and received 78 percent share of the inflows. Out of the $1.4 trillion global FDI inflows, $1.11 trillion went to developed countries. Developing countries received $253 billion or 22 percent of the global FDI inflows (UNCTAD, 2004). The share of FDI inflows to developing countries increased since 1980. The average annual percentage of the FDI inflows to developing countries increased from 25 percent in the 1980s to 30 percent in the 1990s (Banga, 2003). This trend remained virtually unchanged even in the years when global FDI flows declined.

The big sources as well as the recipients of FDI are also the developed countries. Europe and North America remained the largest source of FDI outflows, supplying more than 75 percent of the total FDI since 1991 (ADB, 2004). Out of the $1.2 trillion FDI outflows in 2000, the European Union provided $806 billion and the United States $143 billion. The European Union and the United States received the largest shares, $671 billion and $314 billion respectively, out of the $1.4 trillion FDI inflows (UNCTAD, 2004). [2]

The trend shows FDI inflows have risen in the developing country regions too. From the annual average of $119 billion in the 1992-97 period, FDI inflows to developing countries rose to $252 billion in 2000 (UNCTAD, 2004). Among developing regions, Asia was the recipient of largest FDI inflows, followed by Latin America. In 2000, FDI inflows of $146 billion went to Asia and $98 billion to Latin America. The average annual FDI inflow into Asia and Pacific was about 54 percent of the total in the 1980s, which increased to 61 percent in the 1990s. Asia alone received 97 percent in the 1980s, and 99 percent in the 1990s (UNCTAD, 2003). FDI inflows declined in later years, still Asia received higher inflows than Latin America while Africa and the Pacific regions received the lowest.

The distribution of FDI inflows within Asia is biased toward the East, South East, and South Asia regions. About 72 percent of the total inflows to Asia in the 1980s, and 97 percent in the 1980s, went to these regions. But again, the largest shares of total inflows went to few countries, while other countries of the regions received very little. Four countries in Asia-China, Taiwan, Malaysia, and Singapore together received on average 80 percent of the total FDI inflows to Asia during 1980-2001 (UNCTAD, 2003). All other countries of the region received on average 0 to3 percent of the total FDI inflows to Asia during 1980-2001. Total FDI inward stock received by the countries in the period 1980 to 2001 shows a striking picture. Three countries, China, Indonesia, and Singapore received 85 percent of the total FDI stock

[2] The observed discrepancy between the inflows and the outflows is the amount in the pipeline and also statistical.

during 1980-2001, while Thailand and Taiwan received about 2 percent, and all others received less than 1 percent of the total FDI stock.

Table 1: FDI outflows and inflows by selected countries/regions
(Billions of dollars)

	FDI outflow			FDI inflow		
Region/Economy	1998	2000	2003	1998	2000	2003
World	687	1186	612	691	1388	560
Developed Countries	631	1084	570	473	572	367
European Union	415	806	337	250	671	295
North America	165	187	173	197	381	36
U.S.	131	143	152	174	314	30
Developing countries	53	99	36	194	252	172
Asia	32	84	24	102	146	107
Latin America	20	14	11	82	98	50
Africa	2	1	1	9	9	15

Source: UNCTAD (2004), *World Investment Report, 2004*, UNCTAD, Geneva

The supply-side MNEs used vast majority of the FDI in cross-border mergers and acquisitions (M&A). Greenfield investments (direct investment in new facilities, or expansion of existing facilities) ranged between $200 and $300 billion annually (MIGA, 2002). Greenfield investments that would have impacted economic development were the target of the demand-side countries. However, for their part MNEs considered cross-border mergers and acquisitions less risky than greenfield investments.

Increase of FDI in developing countries accentuated due to various factors such as relaxed government restrictions, privatization programs, and trade liberalization of the FDI seeking countries. In 2000 alone, 69 countries made 150 regulatory changes, 147 of which were favorable to FDI (Banga, 2003). Such promotional activities by the demand-side countries were intended towards influencing supply-side MNEs decisions, which paid off for some developing countries though did not for others.

As developing countries continue to seek private capital through FDI, the overall demand for FDI will grow. But supply rigidity will make it more and more competitive. To be attracted for FDI location the developing countries will have to try harder with more and more of the three "I's"- incentives, institutions, and infrastructure to attract FDI (ADB, 2004). What of these 'I's' are influential in attracting FDI needs to be evaluated.

III. THE THEORETICAL FRAMEWORK OF FDI:

Why manufacturing firms go multinational? Why do firms invest in foreign countries? These questions were central in the evolution of the theory of international investments. Several strands of explanations have been given through various works carried out in the last several decades, but none has emerged that could be regarded as the sole acceptable theory of foreign direct investment.

Early explanations of the international investment phenomena were made with the help of international trade theory. The Heckscher-Ohlin hypothesis in the international trade theory postulates that a country, under assumptions of perfect factor and goods market, exports resources in which it has comparative advantage. Developed countries have comparative advantages in capital, so according to the hypothesis they should export capital to countries which have dearth in capital resources. However, empirical evidences show otherwise, that not only developed countries send international capital to other developed countries, but also receive capital from other countries, even from the capital poor developing countries. Moreover, there is little evidence that the crucial assumption of perfect factor and goods markets holds in the foreign countries.

If capital export was the primary function of the firm, then there would be no need or reason for investors to get involved in the production sector in foreign countries when factor and goods markets are perfect. As far as the direct investments are concerned, there would be little incentive for foreign firms to get involved in having a local subsidiary under risk and uncertainty if factor and goods markets are perfect. On the other hand, imperfect market conditions do not deter foreign direct investments. Rather, firms find market imperfections advantageous for investing in the foreign countries as they would provide incentives to cover transaction costs or to overcome difficulties for entry into the local markets. In the end, international trade theory falls short in explaining the international investment phenomenon.

Several other attempts have been made over the last four decades in developing a more comprehensive theoretical framework of FDI (see Dunning, 1999). The most influential works to that end are by Hymer (1960), Vernon (1966), and Dunning (1977).

Hymer (1960, published in 1976) departs from the international trade and capital theory by distinguishing portfolio investment and direct investment. An export of capital through portfolio investment is nothing but just capital transfer, while direct investment involves production and control of assets through subsidiaries. Foreign direct investment, by definition, is ownership of assets by foreign firms for the purposes of controlling the use of those assets (Graham and Krugman, 1991). FDI involves in the transfer of a bundle of resources including management skills, entrepreneurship, capital, and other resources to the subsidiaries but do not relinquish the ownership of resources or rights to the subsidiaries abroad. MNE's are motivated to produce abroad with the expectation of earning economic rent for the

bundle of resources transferred. The behavior patterns of the multinational firms therefore are different that need fuller explanations.

Hymer provided with the help of industrial organization theory a more plausible microeconomic explanation of FDI. First of all, selection of industries for FDI is not arbitrary or random, rather imperfections in the product and service markets influence FDI decisions. To enter into the domestic market as outsider the firm has to bear extra costs for maintaining overheads, meeting communication and transport expenses, paying higher salaries to expatriate personnel, overcome difficulties due to unfamiliarity with local conditions, policies, rules, and regulations, language, social customs, business and government bureaucracy. To meet these extra costs and still make profit from the economic rent in the competitive markets, the firm must have some kind of firm-specific ownership advantages. The firm's ownership advantages could be in the form of advanced technology, better techniques, R&D capabilities, patents, brand name identification, product differentiation, superior managerial, administrative and marketing skills, access to low-cost funding, exchange rate differentials, economy of scale, etc, which give MNEs competitive edge over the local firms. Whether multinational firms will exploit the firm-specific ownership advantages through the mechanisms of FDI or through licensing, depend on the nature of the advantages and the degree of market imperfection. The higher the degree of market imperfections, the greater will be the incentive of the firm to engage in FDI rather than in licensing.

Later, many economists extended Hymer's industrial organization explanations of FDI. Kindelberger (1969) points out that imperfect market structure in monopolistic competition determines the conduct of the MNEs. He identifies several areas of market imperfections where firm-specific advantages can provide competitive edge to MNEs over local firms by internalizing its production in the host country. They are: product differentiation, special skills and knowledge, unequal access to resources and factors of production, and economy of scale. Caves (1971) presented similar analysis, defined market structure that dictates conduct of the firm. In his view, however, sectors dominated by oligopolies will draw most FDI. If the firm has product differentiation, it will make horizontal investment in the same sector. Without product differentiation firms will go for vertical investment in sectors that are behind in the production.

Vernon (1966) provides another view of explaining FDI through his product cycle hypothesis. He explains that firms which have comparative advantages in technology and innovative capabilities arising from the factor endowments will invent and produce a product in the home country near to its innovative activities and own markets. The product is exported to countries where demand patterns and supply capabilities are similar to the home country. As and when competitors challenging in the home and foreign markets emerge, the firm may shift production abroad where labor and production costs are economically feasible to bear. The production subsidiary supplies the product in the host country and even export back to home country. The firm may try to raise barriers to entry into the oligopolistic competition

(Knickerbocker, 1973), or may attempt to internalize markets so as to reduce market imperfections and external competition (Buckley, 1992). Internalization for skills, technology, raw materials, would lower firm's transaction costs and would protect against exploiting market imperfection by the competitors.

The idea of transaction cost internalization came from Buckley and Casson (1976). The intermediate product markets are imperfect due to high transaction costs, particularly when managed by many firms in an oligopolistic competition. The firm may hold such proprietary assets as marketing, distribution, designs, or such intangible assets as patents, trademarks, innovative capacity, whose transfer may be costly, or difficult to sale or lease. When markets are integrated by firms, the transaction costs could be minimized and market imperfections reduced through internalization.

The importance of internalizing transaction costs resulting from market imperfection leads to the choice of location for production. The internalization theory tries to address the dilemma of deciding between licensing of production to local firms, or arrange own production in a particular location. To this end, the firm must make decisions about the location and the mode of control of operations. If production and control are located in the home country, the firm exports; if production and control are located in the host country, FDI is made. Thus to explain MNE's behavior in FDI there is need to integrate location-specific information with internalization variables.

It is not surprising if these pioneering but diverse strands of work trying to explain FDI phenomenon seem to have failed in presenting a complete theory of FDI. Dunning (1977, 1980, 1988) resolved this problem by bringing them together in an 'eclectic paradigm', popularly known as "OLI' framework. According to this paradigm FDI is determined by three groups of advantages that MNEs may have: ownership advantages, location advantages, and internalization advantages.

A firm has *ownership advantage* over other rival firms if it possesses, or has access to, certain tangible or intangible assets, such as patents, trademarks, blueprints, technology and information, managerial, marketing, and entrepreneurial skills, organizational lay outs and access to intermediate or final product markets. These ownership advantages are firm-specific advantages that provide the firm market power and cost advantages to outweigh other disadvantages it may have in doing business.

A firm must consider the *location advantage* offered by a host country if it decides to produce there instead of producing at home and export to the foreign markets. This advantage derives from the host country's comparative advantage in resource endowment and transaction cost advantage, including economic, socio-cultural, political, legal, institutional factors, market size and structure, tariffs and corporate tax, law and enforcement, government policies and legislation. The host country's attractiveness to FDI provides crucial location advantage to the firm.

Finally, the *internalization advantage* is important to the firm if it finds advantageous to produce the product abroad, particularly if it possesses proprietary product or production process. It is not an obvious decision as it still can produce the product by licensing a local firm instead of setting up a foreign subsidiary. But in order to protect its proprietary intangible assets from market failure in the transaction (e.g. non-availability of suitable licensee, patent or trademark violation without enforcement, etc.), the firm may find it advantageous to have the internal control of the subsidiary, rather than to leave control up to the licensee.

If the firm has only ownership advantages, it would do business with foreign countries through exports, licensing or sale of intangible assets. If it has internalization advantages, the firm may produce abroad through either its subsidiaries or licensee in the host countries. If, however, the firm has location advantages then combined with any of the other advantages FDI becomes profitable venture for the firm. Thus, from host countries point of view, they have very little to offer in terms of ownership advantages and internalization advantages to attract FDI. They can only offer location advantages to attract FDI.

The eclectic OLI paradigm gives a general framework of the economic rationale for international production by the MNEs .But, what motivates the firm to invest abroad? Based on this paradigm Dunning (1993) identifies four reasons for an MNE to invest in foreign countries: for resources (resource-seeking), for markets (market-seeking), for efficiency (efficiency-seeking), and for new strategic assets (strategic asset-seeking).

Resource-seeking investors will place subsidiaries abroad in order to obtain from the resource abundant countries stable and inexpensive supply of raw materials, energy, and factors of production. Cheaper labor and inputs lower cost of production and increase competitiveness of the MNEs. *Market-seeking* investors go to the host country either to protect their market shares from competitors or to open up new markets for their goods and services. They consider the market size, income, and market growth for local consumption. Most often their investment decisions are based on tariff-jumping and getting around transaction or transportation costs. *Efficiency-seeking* investors make rational decisions on resource based structures to gain from the common governance of geographically dispersed activities. Their aim is to produce in a few countries, each having own advantages of factor endowments, location, institutional systems, economic policies, government incentives, and market structures with a view to service large number of markets. Also, they seek countries with macroeconomic and political stability, well developed open and cross-border markets. Lastly, *strategic asset-seeking* investors engage in maintaining and enhancing the firm's international status, with less concern about other advantages of host countries. (Dunning,1993).

Another line of thoughts explaining why a firm would become multinational and how location factors will affect FDI for foreign production was forwarded by combining explanations from the trade theory and the industrial organization theory

under so called 'New trade theory' (Markusen, 1995: and Markusen and Venables ,1998). Following conventional line of trade theories, two distinct types of FDI are identified: market-oriented FDI and export-oriented FDI. One is to better serve the local market; the other is to get lower-cost inputs. (Shatz and Venables, 2000).

Market-oriented FDI are those that typically set up enterprises in the host country to supply goods and services to the needs of the local market. This is also called 'horizontal' FDI as additional plants duplicating same production processes are established in different locations in the host country. The main reason for this type of FDI is the market access into the host country by protecting the existing local market or promoting and expanding new market by providing product and services from within the country, instead of exporting from the home country. Another reason for market-oriented FDI is to reduce costs of transport or tariffs associated with exports and to reduce delivery time of supplying products and services from the home country plants. However, there can be additional costs involved in setting up plants within the host country in terms of fixed and variable costs depending on the factor prices, technology, and economy of scale. Other conditions in the foreign country, e.g. government rules, regulations, and tax systems may translate into additional costs, which can be mitigated through sub-contracting, joint ventures, or licensing. As long as the value of FDI exceeds net of additional fixed costs and savings from variable costs (transport costs and tariffs), the FDI has a strategic value, and as long as it is at the margin, there will be location advantage for the host country. MNE's profit margin, however, will depend on the extent of sales which can be higher in larger market size. Thus, market size, prospects for market growth, level of economic development will provide locational attractiveness to market-oriented FDI.

Export-oriented FDI seeks to use low-cost inputs in the resource endowed host countries to produce goods for exporting to home country or any other country. The outputs produced in the host country can be finished goods, or intermediate inputs required for other plants. They are generally exported to the home country market and so do not depend on the market size of the host country. Export-oriented FDI is also called 'vertical' FDI as it slices the production chain of the firm vertically and sets up part of the chain in the low-cost country. The low-cost input might be cheap labor, raw materials, energy resources, primary commodities, intermediate goods in which the host country has comparative advantages. Country's comparative advantages on factor endowments may however change over time and international mobility of certain factors of production, e.g. capital and technology, may not provide any comparative advantages. It is the location of the immobile factors of production, e.g. human labor and natural resources give comparative advantages that attract export-oriented FDI. The abundance of differential endowment of immobile factors strongly influences the location decisions, the relative abundance of a particular immobile factor will attract FDI for production of those products that use it intensively (Chunalai, 1997)

The different strands of thoughts attempting to explain the FDI phenomena from either international trade or industrial organization theories have offered different

explanations of why firm go multinational, why it decides to produce in host countries with FDI, instead of licensing, and what motivates it to select a location for FDI. Each of these influential thoughts, however, falls short and no convergence to any generalized theory of the FDI phenomenon has emerged. International trade theory does not give any convincing answers to the questions. Hymer gives persuasive argument showing the pitfalls of trade theory in explaining the FDI phenomenon and uses industrial organization to provide much better analysis. However, his approach does not lead to any predictability of MNE's behavior in FDI. Dunning's eclectic OLI paradigm is built from the compromise of all frameworks and provides acceptable reasoning of why a firm would become multinational and why it would invest abroad. His framework based on industrial organization though explains MNE's behavior, it does not adequately address predictability of FDI. Markusen's framework using New trade theory explains why firms invest abroad and identifies types of FDI in the host countries, based on market size and resource endowments. but lacks comprehensiveness. Despite these shortcomings, Dunning's OLI paradigm has remained as the most influential thoughts on FDI. The OLI paradigm has been the basis upon which different factors of FDI are empirically tested.

IV. LOCATION DETERMINANTS OF FDI:

The lack of consensus in the explaining capacity of any particular theoretical framework of the FDI phenomenon has led researchers to rely mainly on empirical evidence. The empirical literature on FDI is extensive with statistical investigations and regression analyses of the determinants. Empirical studies mainly tried to identify significant determinants of FDI with econometric techniques, rather than evolving any theoretical framework. These approaches are so distant from the mainstream theories that empirical evidences of determinants are sometimes termed as 'measurement without theory' (Schneider and Frey, 1985; Chakrabarty, 2001). Moreover, controversies and disagreements relating to methodologies and conflicting findings abound empirical studies. Despite these differences, the empirical studies provide wealth of information regarding robustness of the FDI determinants.

The purpose of this section is twofold: first, to identify from the literature survey the demand-side factors or determinants that attract MNEs for locating their FDI in the host countries, and second, to indicate importance and robustness of the determinants for the host countries to improve attractiveness of the FDI location.

The empirical determinants or factors of FDI can be classified into two groups: supply-side determinants and demand-side determinants (Chunalai, 1997). The supply-side determinants are those that are inherent within the firm, its investment potential and investment pattern, intangible assets, innovative capacity, product life cycle, reaction to oligopolistic competition, and internalization capabilities. According to Dunning's OLI paradigm supply-side determinants entail ownership advantages and internalization

advantages. However, the firm's ownership advantages arise from its own technological and innovative capabilities and relative to the economic development level of the home country. In general, firms in developed countries have higher ownership advantages due to higher technological and innovative capacities and higher levels of economic development. Firms in developed countries also have more ownership advantages from its superior technology, product differentiation, efficient management and entrepreneurial skills, and knowledge-based intangible assets, in particular. Due to the nature of ownership advantages and degree of market imperfections, there are incentives as well as stake for the firm to internalize the use of ownership advantages through FDI and operation control.

The demand-side determinants are those host country's attractiveness that the firm considers location advantages for FDI. If the firm is contented with its supply-side determinants, and is motivated by its ownership advantages and internalization advantages to prefer FDI to exports, then it targets search for appropriate host country for its FDI location where supply-side determinants coincides with the demand-side determinants. There is a large body of literature that shows beneficial impacts of FDI on the host country's economy. Developing countries particularly, being convinced about the beneficial impacts of FDI, indicate their demand for FDI by improving their attractive attributes. The investing firm makes its FDI location decision after considering host of issues, primary among these are external location determinants. For the host countries it would be helpful to know which determinants are attractive to MNE's decision for FDI location so that they could then manipulate these determinants.

The demand-side determinants can be grouped into three main categories: economic, social, and political (Root and Ahmed, 1979; Agarwal, 1980). The majority of the studies on the demand structure of FDI concentrate primarily on economic variables (Dunning, 1973; Lunn , 1980; Culem, 1988). Social and political determinants are either discarded or are given limited consideration (Root and Ahmed, 1979; Dunning, 1981; Schneider and Frey, 1985; Nigh, 1985). In this review, however, we have grouped the locational determinants using UNCTAD classification: economic, government policy, and business facilitation (Table 2). [3]

Economic Determinants

The prevalent view in the literature is that MNEs are mainly attracted by strong economic fundamentals in the host countries (see e.g. Dunning, 1993; Globerman and Shapiro, 1999). The most important economic determinants that affect MNEs location decision for FDI are market size, labor availability and wages, trade

[3] Among the empirical studies, some emphasized developed countries, others considered developing countries (see Billington, 1999 for mentions of specific studies). Since large differences in the factors are likely to exist between developed and developing countries, it might be useful for our study to review those that deal with the developing countries. However, such studies are very few that might not reflect the location factors well. Several studies have examined factors in both developed and developing countries together, but their results cannot be separated. So we decided to review studies without regard to host country emphasis.

liberalization, infrastructure, etc. Econometric studies have tried to find significances of these determinants (Table 3).

Market size:

Market size has been the single most highly used determinant in the FDI literature. The literature on market size determinant of FDI is not only large but also widely accepted due to its significance. Market size and market growth together are considered important location deciding factors in the developing countries, particularly for market-seeking FDI.

Table 2: Location Determinants of FDI

Economic Determinants **Market-seeking** • Market size • Market growth • Market structure • Market access **Resource-seeking** • Low-cost unskilled labor • Skilled labor • Land costs, buildings rents, fees • Raw materials, components, parts **Efficiency-seeking** • Resource and input costs adjusted to productivity • Transportation and communication costs • Membership in regional integration agreements **Asset-seeking** • Embodying firm created innovative assets • Physical infrastructure (roads, ports, power, telecommunication	**Government Policy Determinants** • Economic, social, and political stability • Privatization policy • Trade policy • Tax policy • Capital control policy • Exchange rate policy • Interest rate • Industrial policy • Bilateral/regional investment policy • **Business Facilitation** • Investment incentives • Investment promotion schemes • Reduced corruption • Bureaucratic efficiency • Education and training to raise skill • Property rights protection • Support services and infrastructure e.g. banking, legal, accounting • Pre-and post-investment services • Export promotion zones • Social amenities

Source: Adapted from UNCTAD (2001) Table IV.1

The MNEs are attracted to larger market to exploit the economy of scale and profits by servicing the host country's existing and potential demand with its market-seeking FDI. The demand is often measured by per capita gross domestic product (GDP), which serves as a proxy variable to market size[4]. Empirical studies by Root and Ahmed (1979), Kravis and Lipsey (1982), Nigh (1985), find per capita GDP significant determinant of FDI inflow. Schneider and Frey (1985) find real per capita GNP is the most significant determinant of per capita FDI in developing countries. Culem (1988) finds in UK industries, and Dunning (1980) in US FDI, strong market correlations. Wheeler and Mody (1992), Sader (1993), find strong correlation between market size and FDI in developing economies, while Tsai (1994). Shamsuddin (1998) and Billington (1999) find that market size have positive impact on FDI inflows. Lucas (1993), however, finds weak but positive association between market size and FDI inflows. Edward (1990) finds a negative relationship between real per capita income and FDI inflows. He argues that host countries with lower per capita income will tend to receive higher share of FDI. However, he also finds larger domestic market size attracts MNEs for FDI location. On the other hand, Loree and Guisinger (1995), and Wei (2000) find impact of market size insignificant on FDI inflows. Chakrbarti (2001) in his cross-country study finds strong support for the explanatory power of the market size in host country FDI inflows.

GDP growth is another variable used which serves as proxy to potential market growth. Market growth indicates the prospect for expansion of market size and demand increase over time. Schneider and Frey (1985) and Culem (1988) show market growth has a positive effect on FDI. GDP growth is particularly more significant determinant for small countries showing market potential than GDP as the current size of the incremental national income indicated by GDP would be very small.

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Table 3: Effects of potential determinants on FDI

FDI Determinants	**Positive effect**	**Negative effect**	**Insignificant effect**
Market size	Root & Ahmed (1979) Dunning (1980) Kravis and Lipsey (1982) Nigh (1985) Schneider & Frey (1985) Culem (1988)	Edwards (1990) Jasperson, Aylward, & Knox (2000)	Loree & Guisinger (1995) Wei (2000) Hausmann & Fernandez-Arias (2000)

[4] Other proxies used in some studies but not favored were, per capita GNP, GNP, and absolute GDP to measure market size. See Chakrabarti (2001).

	Wheeler & Mody (1992) Sader (1993) Shamsuddin (1994) Tsai (1994) Billington (1999) Jackson & Markowski (1995) Chakrabarti (2001)		
Growth rate	Root & Ahmed (1979) Lunn (1980) Schneider & Frey (1985) Culem (1988) Wheeler & Mody (1992) Billington (1999)		Nigh (1988) Tsai (1994)
Infrastructure	Root & Ahmed (1979) Wheeler & Mody (1992) Loree & Guisinger (1995) Kumar (2001) Jackson & Markowski (1995) Asiedu (2002)		
Human capital	Noorbakhsh & Paloni (2001) Jackson & Markowski (1995)	Root & Ahmed (1979) Schneider & Frey (1985) Narula (1996)	Lucas (1993) Tsai (1994)
Labor cost	Swedenborg (1979) Nankani (1979) Wheeler & Mody (1992)	Saunders (1982) Flamm (1984) Schneider & Frey (1985) Culem (1988) Shamsuddin (1994) Chunalai (1997)	Lucas (1990) Rolfe & White (1991) Sader (1993) Tsai (1994) Loree & Guisinger (1995) Lipsey (1999)
Trade barrier	Lunn (1980)	Culem (1988)	Blonigen & Feenstra (1996)

Openness	Kravis & Lipsey (1982) Culem (1988) Edwards (1990) Chunalai (1997) Gastanaga, et.al. (1998) Hausmann & Fernandez-Arias (2000) Chakrabarti (2001)	Wheeler & Mody (1992)	
Exchange rate and exchange rate volatility	Edwards (1990) Barrel and Pain (1996)	Caves (1988) Contractor (1990) Froot & Stein (1991) Blonigen (1995) Blonigen & Feenstra (1996) Goldberg & Crawley (2001)	Sader (1991) Goldberg (1993) Blonigen (1997) Campa & Goldberg (1995) Tuman & Emmert (1999)
Tax	Swenson (1994)	Hartman (1984) Gubert & Mutti (1991) Woodward & Rolfe (1993) Hines & Rice (1994) Loree & Guisinger (1995) Cassou (1995) Barrel & Pain (1998) Billington (1999) Wei (2000}	Root & Ahmed (1979) Wheeler & Mody (1992) Jackson & Markowski (1995) Gastanaga et.al. (1998)
Political instability	Green (1972)	Schneider & Frey (1985) Nigh (1985) Edwards (1990)	Wheeler & Mody (1992) Loree & Guisinger (1995) Jasperson, Aylward, & Knox (2000) Hausmann & Fernandez-Arias (2000)

Investment Incentives	Gubert & Mutti (1991) Loree & Guisinger (1995)		Contractor (1991) Caves (1996)
BIT & RI	Rose-Ackerman et.al. (2004) Neumayer & Spess (2004)		Hallward-Driemeir (2003)
Corruption		Wei (2000)	

Source: Adapted from Chakrabarti (2001) and expanded by the author.

MNEs with interest in export-seeking FDI are generally attracted by locations that have lower wages as they would lower production costs. Theoretically the wage hypothesis sounds good, but empirical studies have shown mixed results on the effects of low wages on FDI (Chakrabarty, 2001). Earlier studies including Flamm (1984), Schnieder and Frey (1985), Culem (1988), Shamsuddin (1994), and Mudambi (1995) find higher wages discourages FDI. Wheeler and Mody (1992) find labor cost a dominant factor for FDI in electronics industry and a weak positive factor in manufacturing industry. Tsai (1994) finds strong support for wage hypothesis with data over the 1980s, but weak support in data over the 1970s. Edwards (1980) finds insignificant effects of wage on FDI in data over the 1970s. Caves (1974), Swedenburg (1979), and Nankani (1979) find a positive linkage between real wage and FDI inflow.

Chunalai (1997) argued that most studies of labor cost variables, as surveyed by Dunning (1993), show either wrong signs (positive), or statistically not significant because they use absolute wage rates rather than efficiency wage rates (absolute wages normalized by productivity) . Higher absolute wages are associated with higher productivity and so the positive sign. Using efficiency wages he found labor cost statistically significant location factor affecting FDI inflows into developing countries.

Besides wages, MNEs may also consider availability and productivity of labor in the host country. Availability of more labor, indicated by high unemployment rate, is attractive to investors as wages will be low. Billington (1999) with U.K. data found positive relationship between unemployment rate and FDI inflows.

Although human capital and skill improve productivity, studies have not found much evidence of their impacts to FDI inflows. Root and Ahmed (1979),Schnieder and Frey (1985), and Narula (1996) find negative relationship of human capital proxies with FDI inflows, but Jackson and Markowski (1995) find positive relationship. However, Noorbakhsh, Paloni, and Youssef (2001) using secondary school

enrollment and cumulative years in secondary schools in the 1990s as proxies, find human capital significant determinant of FDI inflows having location-specific advantage for developing countries.

Infrastructure

Infrastructure includes various means of communication, transportation, tele-links. energy networks, etc. Availability of roads, railways, airports, seaports, telephones. information, electricity, is important for increased productivity and efficient physical movement of products and inputs. There is unanimity in the empirical studies that good and efficient infrastructure is important particularly to export-oriented FDI.
Root and Ahmed (1979), Wheeler and Mody (1992), Loree and Guisinger (1995) found infrastructure development significant to selection of FDI location in developing countries. The findings have been supported by Jackson and Markowski (1995) for Asia-Pacific countries and Asiedu (2002) for Africa.

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Kumar (2001) made a cross-country study of infrastructure availability and FDI inflows. In his view export-oriented FDI is efficiency-seeking in nature and has different kind of objectives-its focus is either on production for home-country or on serving third country markets. As such MNE's selection of FDI location is more sensitive to availability of quality infrastructure than overall FDI. His study of FDI of two home countries-U.S. and Japan, and of 66 host countries, found composite infrastructure index has positive significant relationship with third country export-orientation of both home country MNEs and positive significant relationship with home country orientation of U.S. MNEs.

Government Policy

Important role of the government policies in influencing FDI location decisions has been well recognized but whether it is 'bigger' than any other factor is long debated (Loree and Guisinger,1995). The main problem is that statistical analysis alone cannot determine its importance. One problem might be that most government policies are qualitative in nature which is difficult to measure. Sometimes proxies are used. which make interpretations of the result indirect. However, recent studies are focusing on the measurement problem more carefully.
Brewer (1993) lists a number of host government policies (Table 4) that may directly (e.g monetary policies concerning money supply, exchange rates, and interest rates. capital controls, restrictions on profit remittances) or indirectly (e.g. antitrust. intellectual property rights) influence FDI inflow via their effects on market imperfections. His argument is that there are numerous and diverse types of government policies, as shown in the Table 4, including many different dimensions

of variability (e.g. relative cross-national differences in one country's policies compared with that of other countries), which can increase or decrease market imperfections. Whether FDI flows will increase or
decrease depends on the degree of market imperfections in the host country -the greater is the market imperfections, the higher will be the FDI inflows and vice versa. Corporate strategies will, according to the FDI theory, internalize the government policies and market imperfections. Thus the causal path is from the MNE's strategies, to government policies, to market imperfections, to FDI flows (Brewer, 1993).

The government has control and manipulating power over economic factors, and so government policies affect FDI through the economic determinants. Trade liberalization eases entry of the foreign investors. Besides easing entry of foreign investors with liberalization, government policies may be framed to attract FDI inflows through investment incentives and bilateral or regional investment schemes.

Table 4: Government Policies that Affect FDI

Host Government policies that may hinder FDI inflows:	**Host Government policies that may boost FDI inflows**:
• Protectionist import policies • Weak enforcement of intellectual property rights • Weak antitrust (competition policy) • Subsidies on inbound FDI • Overvalued currency • Discriminatory government policies of procurement against foreign firms • Discriminatory technical standards setting processes • Price controls • Restrictions on profit remittances from subsidiaries to parents • Export controls on outputs and import restrictions on inputs	• Liberalization of restrictions on trade and FDI inflow • Privatization of government-owned enterprises • Currency convertibility • Rebates on tariffs on imports of inputs for export-oriented FDI projects • Implementation of anti-dumping measures against imports • Imposition of countervailing duties on imports of goods subsidized by export countries • Enforcement of anti-trust and intellectual property rights

Source: Brewer, Thomas L. 1993, 'Government Policies, Market Imperfections, and Foreign Direct Investment', *Journal of International Business Studies*, 24(1): 101-120.

Trade liberalization

While access to domestic market-given by its size and growth is important to the market-seeking investor, it is less important to export-seeking investor confronting trade restrictions. Host country's trade liberalization attracts FDI inflow as it allows

free movement of goods by lifting restrictions on getting production plants, machineries, and inputs into the host country and exporting products to home or any third country.

The effects of trade liberalization are identified in two ways: trade barriers (tariffs and quotas) and openness to trade (measured by the ratio of exports plus imports to GDP). On trade barriers, Culem (1988) finds significantly negative relationship with FDI inflows, while Blonigen and Feenstra (1996) find that trade barriers have insignificant role in attracting FDI. Lucas (1980) finds positive effect of trade barriers on FDI but his data is considered to be weak to support this finding.

Openness to trade has been of particular concern to export-oriented investors in deciding FDI location. There has been overwhelming support in the empirical studies for positive effects of openness on FDI inflows. Culem (1988), Edwards (1990), and Chunalai (1997) found significantly positive relationship between openness and FDI inflow. Clearly openness encourages FDI. Chakrabarti (2001) finds evidence that in FDI location decision openness has been the most reliable indicator of the attractiveness after market size. With the advent of WTO regime, however, tariffs and quotas have reduced and openness increased, which have lessened concerns on market access by the investors.

Taxes

In order to attract FDI host countries often provide several types of tax incentives to the MNEs, e.g.: reduced rates or tax holidays on corporate profit taxes and income taxes. In recent years these types of fiscal incentives and tax holidays have proliferated particularly in the developing countries (Bora, 2002). However, the literature is inconclusive about their influence on FDI location decisions. Grubert and Mutti (1991), Woodward and Rolfe (1993), Loree and Guisinger (1995), Cassou (1997), Barrel and Pain (1998), and Billington (1999) found corporate taxes to have significant negative effect on FDI inflows. But Root an Ahmed (1978), Wheeler and Mody (1992), Jackson and Markowski (1995), Gastanaga, Nugent, and Pashamova (1998) observed insignificant effect of corporate taxes on FDI flows. Swenson (1994) found positive correlation between taxes and FDI inflows.

The general conclusion that emerged from the econometric studies is that effects of tax incentives on FDI inflow are rather limited.[5] It is because tax incentives discriminate between domestic and foreign firms, between those who show losses in early years and those that do not, between relatively capital-intensive activities and labor-intensive activities. Also, tax incentives are generally given to selected few priority areas, but as competition grows pressure would develop to expand coverage in other areas, making the tax system complex and tax revenue collection problem-ridden (Lim, 2001). All these complexities arising from the incentives might lead to an inefficient and distorted tax system. Furthermore, taxation is a government

[5] For more detailed discussions on tax incentive effects on FDI, see Morrisset and Pirnia, (2000).

apparatus which can be changed very easily, putting investments into difficult position if they are set up on the basis of tax incentives alone.

However, empirical evidence show FDI inflows have continued to show growth in the countries offering tax incentives. Morisset (2003) explained this phenomenon that tax incentives have more effects on the composition of FDI than on its level and that tax incentives are effective to attract FDI in particular sector of industries.

Exchange rates

The exchange rate is long considered to be a crucial determinant of FDI. There are several interpretations of exchange rate's role in location decisions. One of the interpretations is that undervalued currency of the host country makes the investment less expensive than if the currency was overvalued. On the other hand, weak currency of the country may affect firm's exports to the country which may try to offset by setting up plants in the host country. However, in the same token the profit repatriation from the undervalued currency area could also be low due to the weak exchange rate and may face high exchange rate risk. To avoid high exchange rate risk with weak currency, the firm may prefer to invest in a country where the currency is stronger.

The empirical studies on the role of exchange rate and exchange rate volatility provide mixed findings. Caves (1988), Froot and Stein (1991), Blonigen (1995), and Blonigen and Feenstra (1996) report strong negative relationship between a country's exchange rate and FDI. Edwards (1990) and Barrell and Pain (1996) find significantly positive relationship, while Sader (1991), Blonigen (1997), and Tuman and Emmert (1999) observed insignificant relationship between exchange rate and FDI. Goldberg and Crawley (2003) finds negative effect of exchange rate volatility on FDI in some countries, while Goldberg (1993) and Campa and Goldberg (1995) show the relationship insignificant.

Bilateral and Regional Investment Treaties

In recent years, there has been a proliferation of bilateral investment treaties (BIT) between partner countries, which seek to promote and protect FDI with provisos for gradual decrease or elimination of measures and restrictions on entry and operations of the MNEs and for application of positive standards of treatment towards elimination of discrimination against foreign firms (Banga, 2003). Similar provisos have been included in the regional investment treaties (RIT) (or in the regional investment agreements). The main purpose of the government polices to sign BIT and RIT is to provide legal and institutional support to the MNEs for their FDI location in the host country. Whether signing bilateral investment treaties and regional investment agreements have any differential impact on FDI inflows has been the focus in a limited number of empirical studies.

Hallward-Driemeier (2003) looking at the bilateral FDI flows from 20 OECD countries to 31 developing countries over the 1980 to 2000 period observed that BIT between partner countries does not increase FDI flows from developed countries to developing countries. But Rose-Ackerman et.al. (2004) analyzing data for the same period find that developing countries receive higher share of global FDI flows from developed country partners[6]. Neumayer and Spess (2004) find developing countries gain more FDI by signing BIT with developed countries but it may not be substantial to offset the incurred costs in the negotiation process. The study also finds that the functions of BITs provide institutional quality of the host country (e.g. political risk. government stability et.) so that carrying out the obligations of BIT improves institutional quality which attracts more FDI.

Political stability

Does host country's political environment or events affect FDI inflow? Early studies on the determinants of FDI have given some differing views on the impact of political environment on FDI inflow[7] . For example, Green (1972) finds not only that political instability has variable influence on the allocation of U.S. investments. but concludes that there is a positive relationship between the investment flow and political instability in the recipient countries. Thunell (1977), on the other hand, finds that political instability is not directly related to short-term fluctuations in the investment flows, and that the relationship is asymmetric so that the investing firms do not react in the same way when a country becomes more stable as when it becomes unstable.

Schneider and Frey (1985) tested the effects of political instability on FDI inflows exclusively with political variables and jointly with economic variables. They find FDI in developing countries is determined simultaneously by economic and political factors. In other words, political situation per se do not have much effect on FDI but when combined with economic conditions of the host country, together they influence investors' decision a lot.

Wheeler and Mody (1992) included in their study a composite index of socio-political unstable conditions as a risk factor. Their study found weak impact of socio-political risk factor in FDI inflows. They concluded that risk factor has no particular importance and discounted its impact on FDI inflows.

Nonetheless, there is strong belief among researchers that political instability in the host country affects MNE's FDI location decision. Nigh (1985) finds investors are concerned that intra-nation (within country) conflicts promote instability in the host country which would possibly affect their profit or other goals. Developed country investors are more concerned with both intra-nation and inter-nation conflicts in the

[6] These contradictory findings might have caused by the methodological differences. See Neumayer and Spess (2004) for explanations.

[7] See Schneider and Frey (1985) for discussions on the early studies. They have argued that the differing views had come about mostly from the methodological flaws.

developing countries than in the developed countries. They are also concerned that cooperative and conflictive political events have similar deterring effects on their FDI.

Business Facilitation

Investment Incentives

Government policies may offer some direct and indirect investment incentives to attract FDI location. Two categories of FDI incentives most common in developing countries are fiscal incentives and financial incentives. Fiscal incentives include tax concessions, tax holidays, exemption from import duties, and duty drawbacks on exports. Financial incentives include subsidized loans and loan guarantees, publicly funded venture capital for risky investment, and government insurance at preferential rates (Banga, 2003). Other incentives most prevalent in the developing countries are export processing zones and industrial estates.

The empirical evidence on the impact of incentives, however, is mixed. Some of the studies find positive effects (Gruber and Mutti, 1991; Loree and Guisinger, 1995; Taylor, 2000), while other studies (see e.g. Contractor,1991) find weak influence on attracting FDI inflows. Caves (1996) finds incentives generally ineffective once the economic determinants are taken into consideration. Hoeckman and Saggi (2000) supports this view that while incentives are effective in attracting certain typed of FDI, they do not work at the economy wide level. For these reasons, and also not to trigger competing countries to act in similar manner, Loree and Guisinger (1995), Blomstrom and Kokko (2003) advise not to raise investment incentive levels exclusively for the sake of increasing FDI inflow. They argue that investment incentives are not an efficient to raise national welfare.

Discussions

Chakrabarti's (2001) cross-country investigation of the partial correlation between FDI inflows and fundamental economic determinants finds only few of them robust across many of the econometric studies reported in the literature. Despite theoretical strength prevailing in each of these studies, not all of the partial correlations when considered across studies show equal degree of robustness. His sensitivity study yields market size and openness to trade as the most robust determinants, followed by wage, net exports, growth rate, tax, tariff, and exchange rate (in order of likelihood). However, all these determinants affect location decisions for market-seeking and export-seeking FDI but with unequal degree of importance.

Most of the studies on location determinants have been conducted before the 1990s when FDI was in the early stages. Only a few of these studies investigated with recent data.
In recent years, not only FDI has proliferated, but also many changes have taken place in the motives and strategies of the MNEs as well as in the host country

responses to the determinants for attracting FDI location. Many new determinants have shown importance in attracting FDI inflows. Much more emphasis is now given by the host countries in the government policy and regulatory changes. Trade liberalization and bilateral and regional investment agreements have been found most effective determinants to attract FDI. Fiscal incentives offered by the host countries seem less significant than market access and market growth to the developed country investors, but attract developing country investors.

Globalization induced changes in the FDI determinants have not been studied fully yet. Dunning (2002) makes an attempt to compare changes in the motives and strategies of the MNEs between pre- and post-globalization periods. He argued that developed country MNE's motives and strategies of FDI location in the developing countries were mainly market resource seeking, joint ventures/greenfield investments in the 1970/80 period. In 1990/2000, globalization has induced changes in the strategies to more (vertical) efficiency seeking and subcontracting FDI. On the other hand, host country responses in the 1970/80 were predominantly on changing FDI policies, especially regulation of incentives and economic determinants. In the 1990/2000 host countries shifted emphasis to using FDI to upgrade competitive advantage, economic policies and business facilitation. These recent shifts in the MNE's strategies and host country responses are going to affect location determinants. Dunning's insights stress the need for revamping existing empirical determinants in the light of changing strategies of the MNEs. More recent studies are needed to capture the changed positions.

In this respect, Nunnenkamp (2002) made noteworthy contribution in which he agreed with Dunning's argument but wanted more evidence. His study based on 28 developing country survey results of the European Round Table of Industrialists (2000) finds that the traditional market-related determinants (e.g. market size, market growth, entry restrictions, administrative bottleneck, risk factors) are still dominant in the selection of FDI location. Non-traditional determinants (e.g. cost factors, complementary factors of production, skills, openness to trade) have not become more important even with the progress of globalization.

V. ATTRACTIVENESS OF LOCATION DETERMINANTS TO MULTINATIONAL ENTERPRISES

The previous section surveyed the empirical studies in the literature on location determinants of FDI, their significance and robustness determined by data analysis with application of econometric techniques. While identification of the significant determinants from econometric studies provides useful information on attractiveness of FDI location for both demand-sides (the host countries) and supply-sides (MNEs), it is however the MNE's critical view of the determinants that is more important in the decision making for selecting FDI location.

It is rather difficult to know what goes through the actual decision process of MNEs in the selection of any particular location for their FDI. However, several investor

surveys have been conducted in recent years that give views of the MNEs on what demand-side determinants they consider important in the selection of a FDI location. On the other hand, these survey results provide demand-side host countries not only useful information for making their location determinants attractive, but also to build bridges between them and the MNEs on the basis of understanding what influences in their location decisions. In this section we review a few of the MNE opinion surveys.

The World Bank group conducted a survey of 191 MNEs from North America, Europe, and Asia in 2001 with the objectives of understanding their location strategy issues over the next three years (MIGA, 2002). Over 70 percent of the MNEs surveyed indicated their over all strategy to expand overseas, primarily in manufacturing/processing areas. They overwhelmingly expressed inclination to expand through build or lease a facility, or merger and acquisition, rather than expand on an existing facility. They listed the most important objectives when investing overseas as: improved market access, reduced operating costs, improved labor force access, improved productivity, reduced risk, and other factors, all ranked in that order. When asked to rank the 'most critical location factors' in locating operations overseas, 77 percent of the companies responded access to customers. The next cited factors are stable social and political environment (64 percent), ease of doing business (54 percent), reliability and quality of infrastructure and utilities (50 percent). One-third of the respondents cited availability of professional and managerial staff, corruption level, crime and safety, costs of production inputs (labor, utilities, and raw materials), national and local taxes as critical factors .

A.T. Kearney through the Global Business Policy Council annually conducts FDI Confidence Index surveys of CEOs, CFOs and other top decision-makers of the world's largest 1000 MNEs about their opinions on various issues relating to FDI destinations and investment intentions (A.T. Kearney, 2004). These firms are responsible for 70 percent of the global FDI flows in 65 countries which receive more than 90 percent of the global FDI flows.

Table 5: Attractiveness of factors to MNEs for FDI locations in China and India (Percent of respondents)

Factors	China	India
Market size	94	6
Market growth potential	78	22
Access to export market	71	29
Government incentives	66	34
Labor/production costs	65	35
Infrastructure	64	36
Economic/financial stability	61	39
Economic reform	60	40
Quality of life	59	41
Political/social stability	59	41
Tax regime	58	42

Competitor presence	55	45
Consumer sophistication	54	46
Availability of M&A targets	50	50
Regulatory environment	43	57
Cultural barriers	34	66
Transparency	30	70
Rule of law	27	73
Managerial talent	27	73
Highly educated workforce	22	78

Source: Adapted from A.T. Kearney (2004): *FDI Confidence Index.* Global Business Policy Council, Alexandria, Virginia, USA.

The FDI Confidence Index Report did not specify location factors MNEs would consider favorable. However, the report showed the factors that MNEs like in China and India, which made these countries as the world's first and third most attractive FDI locations (A.T. Kearney, 2004) .

Table 6: Critical Corporate Risks Perceived by MNEs in FDI
(Percent of respondents)

Critical Issues	2004	Up/down change from 2003	2003
Traditional Risks:			
Government regulations/legal decisions	64	Down	72
Country financial risk	60	Down	67
Currency/interest rate volatility	51	Down	63
Political and social disturbances	46	Down	62
Absence of rule of law	29	Down	34
Corporate governance issues	30	Up	25
Emerging Risks:			
Theft of intellectual property	28	Up	17
Terrorist attack	26	Up	21
Security threat to personnel/assets	26	Up	22
Product quality/safety	20	Up	19
IT disruption	19	Up	17
Employee fraud or sabotage	10	Up	8

Source: Adapted from AT Kearney (2004): FDI Confidence Index. Global Business Policy Council, Alexandria, Virginia, USA.

The factors listed by the MNEs surprisingly fall in line with the findings of the econometric studies. The most interesting aspect appears to be that the attractive factors in China and India are diametrically opposite. It is because the global investors view both countries to have distinctly different markets and production sectors. China is the leading manufacturer of industrial products and has a fast growing consumer market, while India is a leading provider of IT services and has

growing future market potential. Still, both countries show factors which are attractive to the MNEs.

The MNEs identified the risk factors that they consider critical decision-making issues for investing in a country. They consider government regulations/legal decisions, social and political disturbances, and absence of rule of law to be the most important among the traditional risks. Financial condition and exchange rate volatility are also important. However, they find conditions of traditional risks are improving over the years, while new kinds of risks e.g. violation of intellectual property rights, terrorism and security threats, employee fraud, product safety, are emerging. All together, they point at the significant role of the government and performance of governance as critical to foreign investment decisions.

VI. CONCLUSIONS:

Developing countries are vying for private investments, but although foreign direct investments have risen phenomenally over the years, most of it went to the developed countries. Multinational companies feel more secure and less risk for their investments in the developed countries and they are more attracted to the favorable factors existing there for FDI locations. To influence MNE's decisions on FDI location, the developing countries would have to understand and provide attractive features to the MNEs.

The literature review for the theory of FDI reveals several strands of approaches based on international trade and industrial organization theories, but none seems to have been able to provide any complete explanation and understanding of the FDI phenomenon acceptable to the researchers. Theoretical lapses crept into diverse empirical studies leading to 'measurement without theory'. It was Dunning's eclectic paradigm on ownership, location, and internalization advantages brought the theoretical strands together and gave certain meaningful understanding of the FDI behavior. Nonetheless, Dunning's eclectic paradigm concerns more about the supply-side of FDI, explaining the firm's reasoning for becoming multinational and investing abroad. Selection of FDI location was explored in the extension of the paradigm in which the location decision depended on the intention of the MNE whether it was market-seeking, resource-seeking, or efficiency-seeking. The demand-side characteristics of the host countries were taken into account by the MNEs for matching with the supply-side decisions on FDI location.

In the confusion of theoretical lapse a vast number of econometric studies came to fill the gap in the literature that are essentially 'measurement without theory'. Their findings were mixed, and sometimes conflicted with each other's findings. Yet from the various econometric studies and MNE surveys a number of important location factors have come to light.

First of all, economic fundamentals of the host country are found to be the most important determinants of FDI location, even though there are mixed views about the

significance and robustness of the individual determinants. The less controversial location factors for market-seeking FDIs are market size, market growth, and market access. For export-seeking or resource-seeking FDIs the attractive factors are labor cost and costs of inputs. Infrastructure is an important attractive factor to both types of FDIs. Surprisingly tax, tariff, and government incentives, though found to be important, are not crucial determinants for attracting FDI location. It is not because the MNEs are not interested in the government incentives, but they feel that these are short term factors that the government can quickly change the incentives thus affecting their investments either favorably or unfavorably. As such government incentives should not be the criteria for basing location decisions. MNEs are more concerned with long term government rules and regulations.

There is considerable disagreement existing in the literature about the effects of socio-political instability and corruption factors on the MNE's FDI location decisions. Econometric studies provide mixed results- some find negative effects, others find insignificant relationships between socio-political stability and FDI inflows. However, opinion surveys reveal concerns of the MNEs about political instability and social unrests.

Host country attractiveness to FDI location does not depend on one or few determinants alone. On the other hand, all the desirable factors may not be present in a country. The MNEs take into consideration various demand-side factors cumulatively including business outlook, intra- and inter-country trade issues, national and international trade polices for deciding about their FDI location.

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